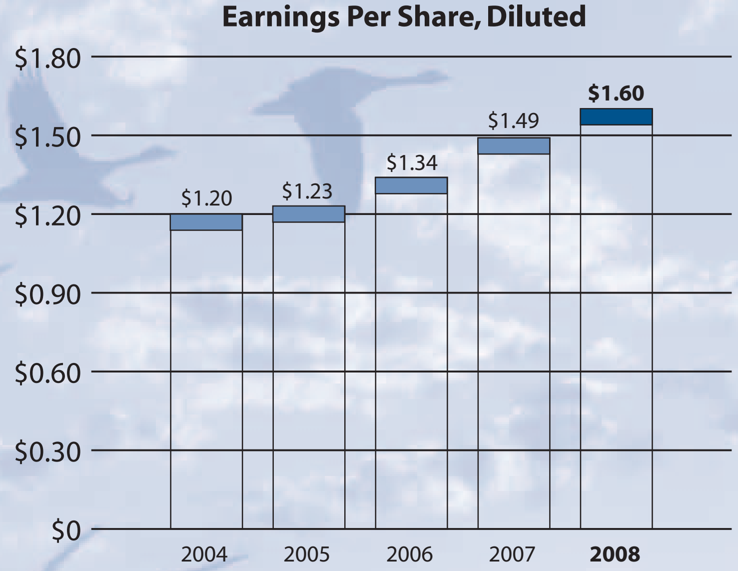
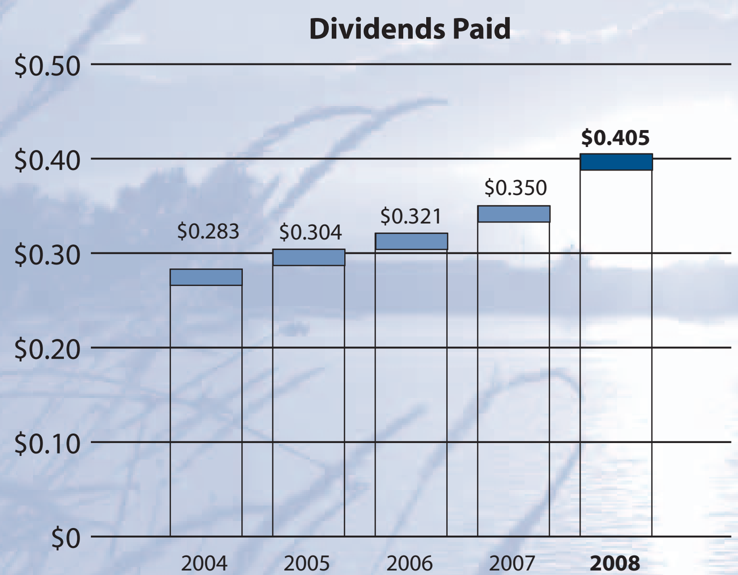
CHESAPEAKE
FINANCIAL SHARES INC.

2 0 0 8 ANNUAL REPORT

CONTENTS



Earnings Per Share, Diluted
$1.80
$1.50
$1.20
$0.90
$0.60
$0.30
$0
$1.20
$1.23
$1.34
$1.49
$1.60
2004
2005
2006
2007
2008



Dividends Paid
$0.50
$0.40
$0.30
$0.20
$0.10
$0
$0.283
$0.304
$0.321
$0.350
$0.405
2004
2005
2006
2007
2008

DEAR SHAREHOLDER

2008 started off with heavy storm clouds on the horizon, and the storm just kept coming throughout the year. What had begun in 2007 as a sub-prime mortgage problem spread early in 2008 into a widespread financial collapse, which precipitated mass foreclosures, the fall of Bear Stearns (merged into JP Morgan Chase), the outright failure of investment bank Lehman Brothers, the shotgun marriage of Merrill Lynch with Bank of America, not to mention the government bailouts of Fannie Mae, Freddie Mac, and the world's largest insurance company, AIG. Along the way, pillars of stability themselves within the investment banking community, Goldman Sachs and Morgan Stanley, both sought the protection of federal backing by adopting a commercial bank holding company charter. Any one of these events in any preceding year would have been earthshaking. The fact that all of these occurred basically in the last eight months of the year signaled 2008 as having the most drastic changes in the banking environment in the last 70 years.

Along with the turmoil in the financial services industry, oil prices over doubled during the middle part of the year, and gas was selling around $4 a gallon at retail pumps. Throw in several large scale hurricanes to the Gulf states in the late summer and early fall coupled with plummeting home prices and increased unemployment (around 7% at year-end), and there is a recipe for a full-fledged recession.

On the political front, Congress and the President in September proposed a $750 billion bailout package to try to right the tilted economy. Most visible among this bailout package was the Troubled Asset Relief Program (TARP) in which banks were offered preferred stock in an effort to shore up their capital positions. To this date, controversy still surrounds the amount of the bailout as well as the usage of funds by the recipients with no clear indication as to the effectiveness of this major infusion. 2008 also was the year in which the United States elected its first African American President, Barack Obama, who rode the banner of change amidst the general disgust of the current environment by constituents nationwide. Additionally, the November election resulted in the Democrats taking control of both houses of Congress in addition to the White House. Locally, Virginia, uncharacteristically, was a blue state in the November elections.

In a needed break from the economic climate, Americans exalted in the display of athleticism and sheer determination by Michael Phelps in his attainment of a record eight gold medals at the 2008 Beijing Olympics, as well as the ease in which Jamaican sprinter Usain Bolt was able to sweep both the 100 and 200 meter sprints, both in world record setting times. 2008 was also marked with the goodbyes of many of those who have changed the world in which we live: Sir Edmund Hillary, William F. Buckley, Jr., Charlton Heston, Cyd Charisse, Harvey Korman, Jim McKay, Tim Russert, and Paul Newman, to name a few.

Belying the economic maelstrom of 2008, Chesapeake Financial Shares was able to post a record year for earnings. Our earnings for the year were $4,601,000, representing a 6% increase over the prior year. Our return on average equity of 13.51% significantly outperformed almost all of our peers within our trade area. Total assets increased to $537,952,000 at year-end as compared to $483,002,000 at the end of 2007, an 11% increase. Mirroring our net income increase, our earnings per share increased to $1.60 as compared to $1.49 at the end of 2007.

With the current volatility and turbulence of the financial markets, much time and effort was spent in 2008 paying close attention to our asset quality and our local economies. Additionally, liquidity and capital have also been prime concerns of management through the balance of 2008. On each of these fronts, we feel that Chesapeake Financial Shares is currently well-poised for the current slowdown. Due to increased earnings and a currently strong balance sheet, your Board of Directors opted not to participate in the TARP plan as offered by the government since it was felt it was not needed nor was it in the best interests of the shareholders. Though 2009 and beyond bodes to be bumpy from an economic front, we feel our current positioning as a strong community bank will provide us opportunities going forward that others may not have. Collectively, as a team, we are optimistic about the future prospects of our organization and the ability to provide above average returns to you, our investors, as well as to be a much needed financial partner in the recovery of each of our local economies.

We truly do appreciate your support as shareholders. We hope that you will take the time to review the contents of this report in detail. Additionally, and most importantly, we hope that you will plan on joining us for our Annual Shareholders Meeting on Friday, April 3, at Rappahannock Westminster-Canterbury in Irvington. We look forward to seeing you there.

Sincerely,

Jeffrey M. Szyperski
Chairman, CEO & President
Chesapeake Financial Shares, Inc.

Douglas D. Monroe, Jr.
Vice Chairman
Chesapeake Financial Shares, Inc.

SELECTED FINANCIAL INFORMATION

	2008	2007	2006	2005	2004
	(Dollars in thousands except ratios and per share amounts)				
Results of Operations					
Interest income	$ 29,708	$ 28,017	$ 24,630	$ 20,634	$ 17,629
Interest expense	13,245	13,471	10,365	6,414	4,332
Net interest income	16,463	14,546	14,265	14,220	13,297
Provision for loan losses	400	160	833	990	1,095
Net interest income after provision for loan losses	16,063	14,386	13,432	13,230	12,202
Noninterest income	15,017	13,484	11,613	9,866	8,030
Noninterest expenses	24,958	21,808	19,643	18,169	15,478
Income before tax	6,122	6,062	5,402	4,927	4,754
Income tax expense	1,521	1,717	1,451	1,254	1,206
Net income	$ 4,601	$ 4,345	$ 3,951	$ 3,673	$ 3,548
Financial Condition					
Total assets	$ 537,952	$ 483,002	$ 418,091	$ 382,694	$ 363,548
Total deposits	427,741	383,214	358,777	328,535	309,367
Net loans	358,917	329,332	297,202	277,401	261,231
Long term debt	55,135	24,243	11,346	6,445	6,541
Trust preferred capital notes	15,465	25,775	10,310	10,310	10,310
Shareholders' equity	30,552	33,663	30,963	28,570	26,766
Average assets	516,018	447,886	403,833	376,126	346,568
Average shareholders' equity	34,062	31,768	29,090	26,829	23,977
Key Financial Ratios					
Return on average assets	0.89%	0.97%	0.98%	0.98%	1.02%
Return on average equity	13.51%	13.73%	13.58%	13.69%	14.80%
Dividends paid as a percent of net income	24.9%	24.8%	23.5%	24.0%	23.0%
Per Share Data					
Net income, assuming dilution	$ 1.60	$ 1.49	$ 1.34	$ 1.23	$ 1.20
Cash dividends declared	$ 0.405	$ 0.350	$ 0.321	$ 0.304	$ 0.283
Book value	$ 10.93	$ 11.91	$ 10.81	$ 9.88	$ 9.24

**Return on average equity is calculated by dividing net income by average equity for the period excluding accumulated other comprehensive income or loss.*

CONSOLIDATED BALANCE SHEETS

	December 31, 2008 and 2007	
	2008	**2007**
Assets		
Cash and due from banks	$ 11,149,371	$ 12,676,152
Federal funds sold	5,705,000	2,272,000
Securities available for sale, at approximate fair value	91,635,902	79,744,941
Restricted stock, at cost	4,289,983	2,715,800
Loans, net of allowance for loan losses of $4,715,574 in 2008 and $4,388,538 in 2007	358,917,320	329,332,297
Premises and equipment, net	17,145,122	16,191,860
Accrued interest receivable	2,288,419	1,931,802
Cash management accounts, net	31,619,663	26,875,420
Other assets	15,201,010	11,261,760
Total assets	$ 537,951,790	$ 483,002,032
Liabilities and Shareholders' Equity		
Deposits:		
Demand accounts	$ 62,192,303	$ 63,432,028
Savings and interest bearing demand deposits	126,497,030	140,784,269
Certificates of deposit		
Denominations less than $100,000	138,901,556	104,559,539
Denominations of $100,000 or more	100,150,202	74,437,917
Total deposits	$ 427,741,091	$ 383,213,753
Federal Home Loan Bank advances	6,000,000	14,000,000
Trust preferred capital notes	15,465,000	25,775,000
Long-term debt	55,135,178	24,242,673
Accrued interest payable	798,917	1,014,869
Accrued expenses and other liabilities	2,259,805	1,092,616
Commitments and contingencies	—	—
Total liabilities	$ 507,399,991	$ 449,338,911
Shareholders' equity:		
Preferred stock, par value $1 per share; authorized 50,000 shares; no shares outstanding	$ —	$ —
Common stock, voting, par value $5 per share; authorized 4,800,000 shares; issued and outstanding 2,795,413 in 2008 and 2,827,474 in 2007	13,977,065	14,137,370
Common stock, nonvoting, par value $5 per share; authorized 635,000 shares; no shares outstanding	—	—
Additional paid-in capital	179,523	173,833
Retained earnings	21,442,637	18,547,146
Accumulated other comprehensive income (loss)	(5,047,426)	804,772
Total shareholders' equity	$ 30,551,799	$ 33,663,121
Total liabilities and shareholders' equity	$ 537,951,790	$ 483,002,032

The accompanying notes are an integral part of these consolidated financial statements.

CONSOLIDATED STATEMENTS OF INCOME

	Years Ended December 31, 2008, 2007 and 2006		
	2008	**2007**	**2006**
Interest Income			
Interest and fees on loans	$ 23,877,932	$ 24,179,850	$ 21,483,909
Interest on federal funds sold	11,602	70,165	88,340
Interest and dividends on securities available for sale:			
Taxable	4,282,768	2,776,632	1,839,746
Nontaxable	1,378,202	878,207	1,124,910
Dividends	158,074	111,664	93,360
Total interest and dividend income	$ 29,708,578	$ 28,016,518	$ 24,630,265
Interest Expense			
Savings and interest bearing accounts	$ 1,863,877	$ 2,881,208	$ 2,671,857
Certificates of deposit			
Denominations less than $100,000	4,576,049	4,500,947	3,645,667
Denominations $100,000 or more	3,611,728	3,532,378	2,501,850
Short-term borrowings and FHLB advances	2,193,272	1,098,348	610,042
Long-term debt and trust preferred capital notes	1,000,360	1,457,988	936,061
Total interest expense	$ 13,245,286	$ 13,470,869	$ 10,365,477
Net interest income	$ 16,463,292	$ 14,545,649	$ 14,264,788
Provision for loan losses	400,000	160,000	833,333
Net interest income after provision for loan losses	$ 16,063,292	$ 14,385,649	$ 13,431,455
Noninterest Income			
Trust income	$ 1,989,460	$ 1,836,446	$ 1,604,664
Service charges	1,810,365	1,881,126	1,428,549
Net gain (loss) on other real estate owned	4,000	(167,964)	24,113
Net gain on sales of securities available for sale	106,929	86,761	69,513
Net gain on sales of premises and equipment	—	—	483,877
Other income	11,105,801	9,848,104	8,002,680
Total noninterest income	$ 15,016,555	$ 13,484,473	$ 11,613,396

The accompanying notes are an integral part of these consolidated financial statements.

CONSOLIDATED STATEMENTS OF INCOME

	Years Ended December 31, 2008, 2007 and 2006		
	2008	**2007**	**2006**
Noninterest Expenses			
Salaries and benefits	$ 12,161,294	$ 10,825,354	$ 9,967,763
Occupancy expenses	3,360,116	3,147,709	2,768,398
Other expenses	9,436,234	7,834,708	6,906,846
Total noninterest expenses	$ 24,957,644	$ 21,807,771	$ 19,643,007
Income before income taxes	$ 6,122,203	$ 6,062,351	$ 5,401,844
Income tax expense	1,521,296	1,717,211	1,451,300
Net income	$ 4,600,907	$ 4,345,140	$ 3,950,544
Earnings per share, basic	$ 1.63	$ 1.53	$ 1.37
Earnings per share, diluted	$ 1.60	$ 1.49	$ 1.34

The accompanying notes are an integral part of these consolidated financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Years Ended December 31, 2008, 2007 and 2006		
	2008	**2007**	**2006**
Cash Flows from Operating Activities			
Net income	$ 4,600,907	$ 4,345,140	$ 3,950,544
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	1,780,628	1,540,572	1,208,958
Provision for loan losses	400,000	160,000	833,333
Provision for cash management account losses	865,000	450,000	200,000
Deferred income tax (benefit)	(65,371)	(41,803)	(39,862)
(Accretion) of discounts, net	(365,641)	(208,634)	(160,215)
Net (gain) on securities available for sale	(106,929)	(86,761)	(69,513)
Impairment loss recognized on preferred stock	100,000	—	—
Net (gain) loss on other real estate owned	(4,000)	167,964	(24,113)
Net (gain) on sales of premises and equipment	—	—	(483,877)
Stock-based compensation	104,000	115,155	118,000
Origination of loans available for sale	(11,209,549)	(1,119,000)	(17,889,872)
Proceeds from sale of loans available for sale	11,209,549	1,119,000	17,889,872
Issuance of common stock for services	103,525	99,049	308,458
Changes in other assets and liabilities:			
(Increase) in accrued interest receivable	(356,617)	(255,835)	(125,778)
(Increase) in other assets	(789,977)	(1,924,760)	(703,723)
Increase (decrease) in accrued interest payable	(215,952)	275,637	486,634
Increase (decrease) in other liabilities	1,167,189	138,945	(627,532)
Net cash provided by operating activities	$ 7,216,762	$ 4,774,669	$ 4,871,314
Cash Flows from Investing Activities			
Purchases of securities available for sale	$ (47,238,714)	$ (44,989,350)	$ (45,191,521)
Proceeds from sales and calls of securities available for sale	6,930,716	10,987,370	18,264,479
Proceeds from maturities of securities available for sale	19,922,640	19,701,181	13,930,339
(Purchase) redemption of restricted stock	(1,574,183)	(1,200,500)	51,100
Proceeds from sale of other real estate	225,288	1,404,363	636,113
Net (increase) in loans	(30,281,311)	(32,290,488)	(23,445,956)
Net (increase) decrease in cash management accounts	(5,540,808)	(9,426,094)	259,388
Proceeds from sale of premises and equipment	—	—	645,305
Other capital expenditures	(2,796,458)	(3,749,495)	(1,761,082)
Net cash (used in) investing activities	$ (60,352,830)	$ (59,563,013)	$ (36,611,835)

The accompanying notes are an integral part of these consolidated financial statements.

	Years Ended December 31, 2008, 2007 and 2006		
	2008	**2007**	**2006**
Cash Flows from Financing Activities			
Net increase (decrease) in short-term borrowings and federal funds purchased	$ (14,000,000)	$ 8,999,000	$ (1,999,000)
Net increase (decrease) in demand accounts, interest-bearing demand accounts and savings accounts	(15,526,964)	275,527	11,288,440
Net increase in certificates of deposits	60,054,302	24,160,798	18,953,945
Net proceeds from issuance of common stock	123,250	232,213	222,325
Repurchase of common stock	(1,046,043)	(1,273,858)	(1,164,312)
Cash dividends	(1,144,763)	(1,001,865)	(927,950)
Proceeds from issuance of trust preferred capital notes	—	15,465,000	—
Redemption of trust preferred capital notes	(10,310,000)	—	—
Proceeds from issuance of long-term debt	37,000,000	13,000,000	5,000,000
Curtailment of long-term debt	(107,495)	(103,277)	(99,237)
Net cash provided by financing activities	$ 55,042,287	$ 59,753,538	$ 31,274,211
Net increase (decrease) in cash and cash equivalents	$ 1,906,219	$ 4,965,194	$ (466,310)
Cash and cash equivalents at beginning of year	14,948,152	9,982,958	10,449,268
Cash and cash equivalents at end of year	$ 16,854,371	$ 14,948,152	$ 9,982,958
Supplemental Disclosures of Cash Flow Information			
Cash paid during the year for:			
Interest	$ 13,461,238	$ 13,195,232	$ 10,093,282
Income taxes	$ 1,808,000	$ 1,895,000	$ 1,624,000
Supplemental Schedule of Noncash Investing and Financing Activities			
Unrealized gain (loss) on securities available for sale	$ (8,866,967)	$ 278,879	$ (172,754)
Other real estate acquired in settlement of loans	$ 296,288	$ —	$ 2,812,012

The accompanying notes are an integral part of these consolidated financial statements.

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

Years Ended December 31, 2008, 2007 and 2006

	Common Stock, Voting	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Comprehensive Income (Loss)	Total
Balance, December 31, 2005	$ 12,043,940	$ 155,230	$ 15,636,280	$ 734,731		$ 28,570,181
Comprehensive income:						
Net income	—	—	3,950,544	—	$ 3,950,544	3,950,544
Other comprehensive loss:						
Unrealized holding losses on securities available for sale, net of deferred income taxes of $35,102	—	—	—	—	(68,139)	—
Reclassification adjustment, net of income taxes of $23,634	—	—	—	—	(45,879)	—
Other comprehensive loss, net of tax	—	—	—	(114,018)	(114,018)	(114,018)
Total comprehensive income	—	—	—	—	$ 3,836,526	—
Exercise of stock options	115,000	107,325	—	—		222,325
Issuance of common stock for services	80,040	228,418	—	—		308,458
Repurchase of common stock	(304,390)	(476,822)	(383,100)	—		(1,164,312)
Stock-based compensation	—	118,000	—	—		118,000
Cash dividends ($0.32 per share)	—	—	(927,950)	—		(927,950)
Balance, December 31, 2006	$ 11,934,590	$ 132,151	$ 18,275,774	$ 620,713		$ 30,963,228
Comprehensive income:						
Net income	—	—	4,345,140	—	$ 4,345,140	4,345,140
Other comprehensive income:						
Unrealized holding gains on securities available for sale, net of deferred income taxes of $124,319	—	—	—	—	241,321	—
Reclassification adjustment, net of income taxes of $29,499	—	—	—	—	(57,262)	—
Other comprehensive income, net of tax	—	—	—	184,059	184,059	184,059
Total comprehensive income	—	—	—	—	$ 4,529,199	—
Exercise of stock options	120,000	112,213	—	—		232,213
Issuance of common stock for services	31,030	68,019	—	—		99,049
Repurchase of common stock	(321,920)	(253,705)	(698,233)	—		(1,273,858)
Stock-based compensation	—	115,155	—	—		115,155
Effect of stock split	2,373,670	—	(2,373,670)	—		—
Cash dividends ($0.35 per share)	—	—	(1,001,865)	—		(1,001,865)
Balance, December 31, 2007	$ 14,137,370	$ 173,833	$ 18,547,146	$ 804,772		$ 33,663,121

The accompanying notes are an integral part of these consolidated financial statements.

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

Years Ended December 31, 2008, 2007 and 2006

	Common Stock, Voting	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Comprehensive Income (Loss)	Total
Balance, December 31, 2008						
(brought forward)	$ 14,137,370	$ 173,833	$ 18,547,146	$ 804,772		$ 33,663,121
Comprehensive loss:						
Net income	—	—	4,600,907	—	$ 4,600,907	4,600,907
Other comprehensive loss:						
Unrealized holding losses on securities available for sale, net of deferred income taxes of $2,978,413	—	—	—	—	(5,781,625)	—
Reclassification adjustment, net of income taxes of $36,356	—	—	—	—	(70,573)	—
Other comprehensive loss, net of tax	—	—	—	(5,852,198)	(5,852,198)	(5,852,198)
Total comprehensive loss	—	—	—	—	$ (1,251,291)	—
Exercise of stock options	102,000	21,250	—	—		123,250
Issuance of common stock for services	26,545	76,980	—	—		103,525
Repurchase of common stock	(288,850)	(196,540)	(560,653)	—		(1,046,043)
Stock-based compensation	—	104,000	—	—		104,000
Cash dividends ($0.405 per share)	—	—	(1,144,763)	—		(1,144,763)
Balance, December 31, 2008	$ 13,977,065	$ 179,523	$ 21,442,637	$ (5,047,426)		$ 30,551,799

The accompanying notes are an integral part of these consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1. Summary of Significant Accounting Policies

General

Chesapeake Financial Shares, Inc. ("CFS") owns 100% of Chesapeake Bank (the "Bank"), Chesapeake Investment Group, Inc. ("CIG"), and CFS Capital Trust (the "Trusts"). Three additional companies, Chesapeake Financial Group, Inc., Chesapeake Insurance Agency, Inc. T/A Chesapeake Investment Services and Chesapeake Trust Company (the "Trust Company") are wholly-owned subsidiaries of CIG. The consolidated financial statements include the accounts of CFS and its wholly-owned subsidiaries. All significant intercompany accounts have been eliminated.

The accounting and reporting policies of CFS are in accordance with accounting principles generally accepted in the United States of America and conform to general practices within the banking industry. The more significant of these policies are summarized below.

Stock Splits

On July 20, 2007, the Board of Directors approved a 6-for-5 stock split of CFS's common stock. All per share information for all periods presented has been retroactively restated to reflect the stock split.

Securities

Debt securities that management has the positive intent and ability to hold to maturity are classified as "held to maturity" and recorded at amortized cost. Securities not classified as held to maturity or trading, including equity securities with readily determinable fair values, are classified as "available for sale" and recorded at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income. CFS classifies all securities as available for sale.

Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Declines in the fair value of available for sale and held to maturity securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses. In estimating other than temporary impairment losses, management considers (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of CFS to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

Loans

The Bank grants mortgage, commercial and consumer loans to customers. A substantial portion of the loan portfolio is represented by mortgage loans throughout the Northern Neck, Middle Peninsula, Williamsburg, and James City County areas of Virginia. The ability of the Bank's debtors to honor their contracts is dependent upon the real estate and general economic conditions in these areas.

Loans are stated at face value, net of unearned discount and the allowance for loan losses. Interest is computed by methods which result in level rates of return on principal. Nonrefundable loan fees and direct loan origination costs are recognized in operations when received and incurred. The impact of this methodology is not significantly different from recognizing the net of the fees and costs over the contractual life of the related loan.

Loans are placed on nonaccrual status when a loan is specifically determined to be impaired or when principal or interest is delinquent for 90 days or more. Any unpaid interest previously accrued on those loans is reversed from income. Interest income generally is not recognized on specific impaired loans unless the likelihood of further loss is remote. Interest payments received on such loans are applied as a reduction of the loan principal balance. Interest income on other nonaccrual loans is recognized only to the extent of interest payments received.

Mortgage loans held for resale are stated at the lower of cost or market on an individual loan basis. Loan discounts and origination fees received on loans held for resale are deferred until the related loans are sold to third party investors. Gains are recognized at the time of sale.

A loan is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan-by-loan basis for commercial and construction loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent.

Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Bank does not separately identify individual consumer and residential loans for impairment disclosures.

Allowance for Loan Losses

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectibility of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

The allowance consists of specific, general and unallocated components. The specific component relates to loans that are classified as doubtful or substandard. For such loans that are also classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers non-classified loans and is based on historical loss experience adjusted for qualitative factors. An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

Premises and Equipment

Premises and equipment are stated at cost less accumulated depreciation. Depreciation is computed using both straight-line and accelerated methods over the assets' estimated useful lives. Estimated useful lives range from 10 to 39 years for buildings and 3 to 7 years for furniture, fixtures and equipment.

Foreclosed Properties

Foreclosed properties are recorded at the lower of the outstanding loan balance at the time of foreclosure or the estimated fair value less estimated costs to sell. At foreclosure, any excess of loan balance over the fair value of the property is charged to the allowance for loan losses. Such carrying value is periodically reevaluated and written down if there is an indicated decline in fair value. Costs to bring a property to salable condition are capitalized up to the fair value of the property, while costs to maintain a property in salable condition are expensed as incurred. The Bank included $1,218,141 and $1,143,141 of foreclosed properties in other assets at December 31, 2008 and 2007, respectively.

Trust Company Assets

Securities and other property held by the Trust Company in a fiduciary or agency capacity are not assets of CFS and are not included in the accompanying consolidated financial statements.

Income Taxes

Deferred taxes are provided on a liability method whereby deferred tax assets are recognized for deductible temporary differences, operating loss carryforwards, and tax credit carryforwards. Deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the reported amounts of assets and liabilities and their tax bases. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment.

Consolidated Statements of Cash Flows

For purposes of the statement of cash flows, CFS considers cash equivalents to include cash on hand, amounts due from banks and federal funds sold.

Advertising Costs

CFS follows the policy of charging the production costs of advertising to expense as incurred.

Use of Estimates

In preparing consolidated financial statements in conformity with accounting principles generally accepted in the United States of America, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses and the valuation of deferred tax assets.

Earnings Per Share

Basic earnings per share represents income available to common shareholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per share reflects additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance. Potential common shares that may be issued by CFS relate solely to outstanding stock options and are determined using the treasury stock method. All amounts have been retroactively restated to reflect the 6-for-5 stock split in 2007.

Defined Benefit Plan

CFS had a noncontributory, defined benefit pension plan for all full-time employees over 18 years of age. Benefits were based upon years of service and the employees' compensation. CFS funded pension costs in accordance with the funding provisions of the Employee Retirement Income Security Act. Refer to Note 7 for a description of the freezing of CFS's defined benefit plan and termination in 2006.

Cash Management Accounts

The Bank purchases trade accounts receivable from customers. These receivables are stated at face value net of discounts and an allowance for losses. CFS retains reserves against these customer balances in the form of deposit accounts to cover unpaid receivables, returns, allowances and other adjustments.

Stock-Based Compensation

At December 31, 2008, CFS had two stock-based employee compensation plans, which are described more fully in Note 8. Beginning January 1, 2006, CFS adopted SFAS No. 123 (revised 2004), "Share-Based Payment" and began to recognize the cost of stock-based payments to employees based on the fair value of those awards at the date of grant. Stock-based compensation is estimated at the date of grant using the Black-Scholes option valuation model for determining fair value.

Recent Accounting Pronouncements

In June 2006, the Financial Accounting Standards Board (FASB) issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes: An Interpretation of FASB Statement No. 109" (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an entity's financial statements in accordance with SFAS 109. The Interpretation prescribes a recognition threshold and measurement principles for the financial statement recognition and measurement of tax positions taken or expected to be taken on a tax return that are not certain to be realized. FIN 48 is effective for fiscal years beginning after December 15, 2006. On December 30, 2008, the FASB issued a staff position, FIN 48-3, "Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises," which defers the effective date for CFS to fiscal years beginning after December 15, 2008. CFS does not expect a material impact on the consolidated financial statements as a result of implementing this interpretation.

In September 2006, the FASB reached a consensus on Emerging Issues Task Force (EITF) Issue 06-4, "Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements," (EITF Issue 06-4). In March 2007, the FASB reached a consensus on EITF Issue 06-10, "Accounting for Collateral Assignment Split-Dollar Life Insurance Arrangements," (EITF Issue 06-10). Both of these standards require a company to recognize an obligation over an employee's service period based upon the substantive agreement with the employee such as the promise to maintain a life insurance policy or provide a death benefit postretirement. CFS adopted the provisions of these standards effective January 1, 2008. The adoption of these standards was not material to the consolidated financial statements.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, "Fair Value Measurements" (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 does not require any new fair value measurements, but rather, provides enhanced guidance to other pronouncements that require or permit assets or liabilities to be measured at fair value. This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those years. The FASB has approved a one-year deferral for the implementation of the Statement for nonfinancial assets and nonfinancial liabilities that are recognized or disclosed at fair value in the financial statements on a nonrecurring basis. CFS adopted SFAS 157 effective January 1, 2008. CFS decided not to report any existing financial assets or liabilities at fair value that are not already reported, thus the adoption of this statement did not have a material impact on the consolidated financial statements.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities" (SFAS 159). This Statement permits entities to choose to measure many financial instruments and certain other items at fair value. The objective of this Statement is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. The fair value option established by this Statement permits all entities to choose to measure eligible items at fair value at specified election dates. A business entity shall report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. The fair value option may be applied instrument by instrument and is irrevocable. SFAS 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007, with early adoption available in certain circumstances. CFS adopted SFAS 159 effective January 1, 2008. The adoption of SFAS 159 was not material to the consolidated financial statements.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 141(R), "Business Combinations" (SFAS 141(R)). The Standard will significantly change the financial accounting and reporting of business combination transactions. SFAS 141(R) establishes principles for how an acquirer recognizes and measures the identifiable assets acquired, liabilities assumed, and any noncontrolling interest in the acquiree; recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase; and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. SFAS 141(R) is effective for acquisition dates on or after the beginning of an entity's first year that begins after December 15, 2008. CFS does not expect the implementation of SFAS 141(R) to have a material impact on its consolidated financial statements, at this time.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 160, "Noncontrolling Interests in Consolidated Financial Statements an Amendment of ARB No. 51" (SFAS 160). The Standard will significantly change the financial accounting and reporting of noncontrolling (or minority) interests in consolidated financial statements. SFAS 160 is effective as of the beginning of an entity's first fiscal year that begins after December 15, 2008, with early adoption prohibited. CFS does not expect the implementation of SFAS 160 to have a material impact on its consolidated financial statements, at this time.

In March 2008, the FASB issued SFAS No. 161, "Disclosures about Derivative Instruments and Hedging Activities – an amendment of SFAS No. 133," (SFAS 161). SFAS 161 requires that an entity provide enhanced disclosures related to derivative and hedging activities. SFAS 161 is effective for CFS on January 1, 2009.

In May 2008, the FASB issued SFAS No. 162, "The Hierarchy of Generally Accepted Accounting Principles," (SFAS 162). SFAS 162 identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles. SFAS 162 is effective 60 days following the SEC's approval of the Public Company Accounting Oversight Board amendments to AU Section 411, "The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles." Management does not expect the adoption of the provision of SFAS 162 to have any impact on the consolidated financial statements.

In October 2008, the FASB issued FSP FAS 157-3, "Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active" (FSP 157-3). FSP 157-3 clarifies the application of SFAS 157 in determining the fair value of a financial asset during periods of inactive markets. FSP 157-3 was effective as of September 30, 2008 and did not have material impact on CFS's consolidated financial statements.

In January 2009, the FASB reached a consensus on EITF Issue 99-20-1. This FSP amends the impairment guidance in EITF Issue 99-20, "Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Beneficial Interests That Continue to Be Held by a Transferor in Securitized Financial Assets," to achieve more consistent determination of whether an other-than-temporary impairment has occurred. The FSP also retains and emphasizes the objective of an other-than-temporary impairment assessment and the related disclosure requirements in SFAS 115, "Accounting for Certain Investments in Debt and Equity Securities," and other related guidance. The FSP is effective for interim and annual reporting periods ending after December 15, 2008 and shall be applied prospectively. The FSP was effective as of December 31, 2008 and did not have a material impact on the consolidated financial statements.

Note 2. Securities

Amortized cost and fair values of securities available for sale as of December 31, 2008 and 2007, are as follows:

2008	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
Securities of state and political subdivisions	$ 33,353,917	$ 1,037,528	$ (1,193,269)	$ 33,198,176
Mortgage-backed securities	65,929,600	657,789	(8,149,663)	58,437,726
Total	$ 99,283,517	$ 1,695,317	$ (9,342,932)	$ 91,635,902

2007	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
Securities of state and political subdivisions	$ 20,171,610	$ 955,429	$ (40,887)	$ 21,086,152
Mortgage-backed securities	58,253,979	560,290	(255,480)	58,558,789
Preferred stock	100,000	—	—	100,000
Total	$ 78,525,589	$ 1,515,719	$ (296,367)	$ 79,744,941

Information pertaining to securities with gross unrealized losses at December 31, 2008 and 2007, aggregated by investment category and length of time that individual securities have been in a continuous loss position, follows:

2008	Less Than 12 Months		12 Months or More	
	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)
Securities of state and political subdivisions	$ 12,625,353	$ (643,820)	$ 1,636,528	$ (549,449)
Mortgage-backed securities	31,207,364	(6,889,948)	3,644,550	(1,259,715)
	$ 43,832,717	$ (7,533,768)	$ 5,281,078	$ (1,809,164)

2007	Less Than 12 Months		12 Months or More	
	Fair Value	Unrealized (Loss)	Fair Value	Unrealized (Loss)
Securities of state and political subdivisions	$ 2,557,079	$ (25,613)	$ 307,283	$ (15,274)
Mortgage-backed securities	20,639,532	(235,818)	3,344,641	(19,662)
	$ 23,196,611	$ (261,431)	$ 3,651,924	$ (34,936)

Management evaluates securities for other-than-temporary impairment annually, and more frequently when economic or market concerns warrant such evaluation. Consideration is given to (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of CFS to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value.

The unrealized loss positions at December 31, 2008 were directly related to interest rate movements. Bonds with an unrealized loss position of twelve months or more included five mortgage-backed securities and four municipal bonds. Bonds with an unrealized loss position less than twelve months in duration included 41 mortgage-backed securities and 24 municipal bonds. Management continuously monitors the mortgage-backed securities portfolio for potential permanent impairment. Analytical tools used include comprehensive credit risk analysis. CFS strives to maintain exposure only to securities that have credit support in excess of original issue levels. Generally, it is CFS's intent to hold the securities in the previous table for a time necessary to recover the amortized cost unless prudent business decisions warrant otherwise.

The amortized cost and fair value of securities available for sale as of December 31, 2008, by contractual maturity are shown below. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations without penalties.

	Amortized Cost	Fair Value
Due in one year or less	$ 10,113,191	$ 10,418,654
Due after one year through five years	32,008,316	30,848,468
Due after five years through ten years	36,165,356	32,533,532
Due after ten years	20,996,654	17,835,248
Total	$ 99,283,517	$ 91,635,902

Proceeds from sales and calls of securities available for sale during 2008, 2007 and 2006 were $6,390,716, $10,987,370 and $18,264,479, respectively. Gross realized gains amounted to $106,929, $95,032, and $172,067 in 2008, 2007 and 2006. Gross realized losses amounted to $8,271 and $102,554 in 2007 and 2006, and there were no gross realized losses during 2008. The tax provision applicable to these net realized gains amounted to $36,356, $29,499 and $23,634 in 2008, 2007 and 2006, respectively.

The amortized cost of securities pledged to secure public deposits, borrowings from the Federal Reserve Bank, fiduciary powers and for other purposes required or permitted by law amounted to $80,158,025 and $62,307,663 at December 31, 2008 and 2007, respectively.

Note 3. Loans

A summary of the balances of loans follows:

	December 31, 2008	December 31, 2007
Commercial	$ 213,966,393	$ 193,200,806
Real estate mortgage	95,157,530	82,362,880
Real estate construction	29,570,243	30,173,387
Consumer	21,042,442	23,380,959
Participations with other banks	3,746,521	4,073,876
Other	149,765	528,927
	$ 363,632,894	$ 333,720,835
Less: Allowance for loan losses	4,715,574	4,388,538
Loans, net	$ 358,917,320	$ 329,332,297

Overdrafts totaling $190,419 and $462,297 at December 31, 2008 and 2007, respectively, were reclassified from deposits to loans.

An analysis of the allowance for loan losses follows:

	December 31,		
	2008	2007	2006
Balance at beginning of year	$ 4,388,538	$ 4,342,174	$ 4,199,745
Provision for loan losses	400,000	160,000	833,333
Loans charged off	(319,957)	(136,387)	(747,721)
Recoveries on loans previously charged off	246,993	22,751	56,817
Balance at end of year	$ 4,715,574	$ 4,388,538	$ 4,342,174

The following is a summary of information pertaining to impaired loans:

	December 31,		
	2008	2007	2006
Impaired loans without a valuation allowance	$ 2,524,428	$ 327,075	$ 141,388
Impaired loans with a valuation allowance	—	2,803,081	3,191,873
Total impaired loans	$ 2,524,428	$ 3,130,156	$ 3,333,261
Valuation allowance related to impaired loans	$ —	$ 614,343	$ 803,282

	Years Ended December 31,		
	2008	2007	2006
Average investment in impaired loans	$ 2,629,682	$ 3,231,709	$ 3,406,102
Interest income recognized	—	—	—

No additional funds are committed to be advanced in connection with impaired loans.

Nonaccrual loans excluded from impaired loan disclosure under SFAS No. 114 amounted to $138,254 , $818,185 and $453,233 at December 31, 2008, 2007 and 2006, respectively. If interest on these loans had been accrued, such income would have approximated $10,723, $36,484 and $70,051 at December 31, 2008, 2007 and 2006, respectively.

There were no loans 90 days past due and still accruing interest at December 31, 2008, 2007 and 2006.

Note 4. Premises and Equipment

A summary of the cost and accumulated depreciation of premises and equipment follows:

	December 31,	
	2008	2007
Land	$ 3,790,653	$ 3,790,653
Buildings	11,585,176	11,537,047
Furniture, fixtures and improvements	1,825,733	1,771,163
Mechanical equipment	6,924,759	5,995,856
Leasehold improvements	3,020,307	2,354,995
Construction in progress	770,466	28,313
	$ 27,917,094	$ 25,478,027
Less accumulated depreciation	10,771,972	9,286,167
	$ 17,145,122	$ 16,191,860

For the years ended December 31, 2008, 2007 and 2006, depreciation expense was $1,582,941, $1,392,423 and $1,035,246, respectively.

Note 5. Borrowings

CFS's fixed-rate long-term debt of $55,135,178 at December 31, 2008 matures through 2018. $530,205 of the long-term debt is secured by a deed of trust on property located in Lancaster County, Virginia with a carrying value of approximately $675,000. $54,000,000 of the long-term debt consists of fixed-rate credits from the Federal Home Loan Bank (FHLB). These credits have rates ranging from 2.06% to 5.25% and mature through 2018. The remainder of the long-term debt is an advance from the FHLB's EDGE Project. CFS borrowed $1,000,000 at 1.00% to fund a local non-profit project. The remaining balance at December 31, 2008 for this borrowing was $604,973. Aggregate maturities during the next five years are: 2009, $5,111,901; 2010, $18,116,509; 2011, $5,621,089; 2012, $126,111; and 2013, $12,631,336.

CFS has unsecured lines of credit with correspondent banks totaling $35,700,000 available for overnight borrowing and an undrawn line of credit of $4,000,000 secured by CFS stock.

Note 6. Income Taxes

The components of the net deferred tax asset, included in other assets, are as follows:

	December 31,	
	2008	**2007**
Deferred tax assets:		
Allowance for loan and cash management account losses	$ 1,726,838	$ 1,626,147
Securities available for sale	2,600,189	—
Other real estate	40,539	26,786
Deferred compensation	83,355	88,856
Premises and equipment	126,949	158,638
Other	3,646	15,529
	$ 4,581,516	$ 1,915,956
Deferred tax liabilities:		
Securities available for sale	$ —	$ 414,580
Net deferred tax asset	$ 4,581,516	$ 1,501,376

The provision for income taxes charged to operations for the years ended December 31, 2008, 2007 and 2006, consists of the following:

	2008	**2007**	**2006**
Current tax expense	$ 1,586,667	$ 1,759,014	$ 1,491,162
Deferred tax (benefit)	(65,371)	(41,803)	(39,862)
	$ 1,521,296	$ 1,717,211	$ 1,451,300

The income tax provision differs from the amount of income tax determined by applying the U.S. federal income tax rate to pretax income for the years ended December 31, 2008, 2007 and 2006, due to the following:

	2008	**2007**	**2006**
Computed "expected" tax expense	$ 2,081,549	$ 2,061,199	$ 1,836,627
(Decrease) in income taxes resulting from:			
Tax exempt interest income	(541,854)	(320,542)	(378,541)
Other	(18,399)	(23,446)	(6,786)
	$ 1,521,296	$ 1,717,211	$ 1,451,300

Note 7. Employee Benefit Plans

Effective December 31, 2005, CFS approved the freezing and termination of its defined benefit pension plan. The plan was terminated effective January 31, 2006 after receiving final approval from the Pension Benefit Guaranty Corporation and making distributions in the form of lump-sum cash payments to plan participants and purchasing nonparticipating annuity contracts. Plan assets at December 31, 2005 were sufficient to fund the termination. CFS recognized a gain of $174,396 upon termination of the plan. This gain is included in other income on the consolidated statements of income. No net periodic benefit cost was recognized in 2008, 2007 or 2006.

The following tables provide a reconciliation of the changes in the plan's benefit obligations and fair value of assets for the year ended December 31, 2006:

	2006
Change in Benefit Obligation	
Benefit obligation, beginning	$ 5,446,897
Termination adjustment	(1,682,658)
Interest cost	271,320
Termination of plan	(4,035,559)
Benefit obligation, ending	$ —
Change in Plan Assets	
Fair value of plan assets, beginning	$ 3,458,482
Actual return on plan assets	271,320
Employer contributions	305,757
Termination of plan - distributions	(4,035,559)
Fair value of plan assets, ending	$ —

Deferred Compensation Agreements

CFS has a deferred compensation agreement providing for monthly payments to an officer commencing at retirement. The liability under this agreement was accrued over the officer's period of employment such that the present value of the monthly payments was accrued by retirement date. CFS funded the deferred compensation commitment through life insurance policies on the officer. The officer is currently receiving benefits under this plan.

Employee Stock Ownership Plan

Generally, full-time employees who have completed one calendar year of service are eligible. Contributions each year are at the discretion of the Board of Directors, within certain limitations prescribed by Federal tax regulations. CFS made cash contributions to the plan of $299,928, $270,000 and $270,000 during the years ended December 31, 2008, 2007 and 2006, respectively. These contributions are included in salaries and benefits in the accompanying income statements. An employee's proportional ownership in the plan assets vests on an increasing scale over 7 years, or sooner under certain circumstances. The plan intends to invest contributions received in shares of CFS common stock. Dividends paid on shares held by the plan are charged to retained earnings. All shares held by the plan are treated as outstanding in computing CFS's earnings per share.

401(k) Plan

CFS has adopted a contributory 401(k) plan that covers substantially all employees. Under the plan, employees may elect to defer up to 100% of their salary, subject to Internal Revenue Service limits. CFS will make a matching contribution of 100% of the first 3% and 50% of the second 3% of the employee's salary deferred. CFS also makes discretionary contributions to the plan. Total expense related to the plan was $566,610, $507,204 and $491,566 for 2008, 2007 and 2006, respectively.

Note 8. Stock Option Plans

In 1996, CFS adopted an incentive stock option plan that reserved for issuance 252,000 shares of CFS's voting common stock. The plan's expiration date was March 31, 2006. On April 1, 2005, CFS's shareholders approved an incentive stock option plan under which options may be granted to certain key employees. The plan reserves 156,000 shares of voting common stock for issuance as options and expires on January 21, 2015. The compensation cost that has been charged against income for those plans was $104,000, $115,155 and $118,000 for the years ended December 31, 2008, 2007 and 2006, respectively. No income tax benefit was recognized in the income statement for stock-based compensation arrangements for the years ended December 31, 2008, 2007 and 2006.

The stock option plans require that options be granted at an exercise price equal to at least 100% of the fair market value of the common stock on the date of the grant; however, for those individuals who own more than 10% of the stock of CFS, the option price must be at least 110% of the fair market value on the date of grant. Such options are generally not exercisable until three years from the date of issuance and require continuous employment during the period prior to exercise. The options will expire in no more than ten years after the date of grant. All information for all periods presented has been retroactively restated to reflect the 6-for-5 stock split in 2007.

A summary of the option activity under the plans at December 31, 2008 and changes during the year then ended are as follows:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at beginning of year	227,640	$ 12.73		
Granted	39,900	16.50		
Exercised	(20,400)	6.05		
Outstanding at end of year	247,140	$ 13.89	6.4 years	$ 830,390
Options exercisable, end of year	136,440	$ 11.90	4.9 years	$ 729,954

The weighted-average grant date fair value of options granted during the years ended December 31, 2008, 2007 and 2006 was $2.95, $3.03 and $3.28, respectively. The total intrinsic value of options exercised during the years ended December 31, 2008 and 2007 was $242,000 and $235,000, respectively.

The fair value of each option grant is estimated on the date of the grant using the Black-Scholes option-pricing model with the assumptions noted in the following table. Expected volatility is based on the historic volatility of CFS's stock price over the expected life of the options. The expected term is estimated as the average of the contractual life and vesting schedule for the respective options. The risk-free interest rate is the U.S. Treasury zero-coupon issue with a remaining term equal to the expected term of the options granted. The dividend yield is estimated as the ratio of CFS's historical dividends paid per share of common stock to the stock price on the date of grant.

	Years Ended December 31,		
	2008	2007	2006
Dividend yield	2.04%	2.11%	2.13%
Expected term	6 years	6 years	6 years
Expected volatility	17.60%	14.67%	15.55%
Risk-free interest rate	3.28%	4.60%	4.95%

As of December 31, 2008, there was $142,830 of total unrecognized compensation cost related to nonvested stock-based compensation arrangements granted under the plans. That cost is expected to be recognized over a weighted average period of 1.75 years.

Note 9. Shareholders' Equity

During 2008, 2007 and 2006, CFS issued 5,309 shares, 6,206 shares and 6,156 shares, respectively, of common stock to its directors for partial compensation. All information has been retroactively restated to reflect the 6-for-5 stock split in 2007.

Note 10. Commitments and Contingencies

CFS leases certain facilities and equipment under operating leases which expire at various dates through 2013. These leases generally contain renewal options and require CFS to pay taxes, insurance, maintenance and other expenses in addition to the minimum normal rentals.

Minimum rental payments under these operating lease agreements as of December 31, 2008 are as follows:

Year Ending December 31,	
2009	$ 218,756
2010	223,909
2011	241,113
2012	246,619
2013	252,142

Rent expense under operating leases aggregated $316,118, $247,383 and $239,003 for the years ended December 31, 2008, 2007 and 2006, respectively.

As a member of the Federal Reserve System, the Bank is required to maintain certain average reserve balances. For the final weekly reporting period in the years ended December 31, 2008 and 2007, the aggregate amounts of daily average required balances were approximately $1,317,000 and $1,674,000, respectively.

Note 11. Related Party Transactions

Officers, directors and their affiliates had borrowings of $22,564,135 and $20,606,591 at December 31, 2008 and 2007, respectively, with the Bank.

Changes in borrowings during 2008 were as follows:

Balance, December 31, 2007	$ 20,606,591
Additions	2,344,990
Payments	(387,446)
Balance, December 31, 2008	$ 22,564,135

These transactions occurred in the ordinary course of business on substantially the same terms as those prevailing at the time for comparable transactions with unrelated persons.

Note 12. Other Income and Expenses

The principal components of "Other Income" in the consolidated statements of income are:

	2008	2007	2006
Cash management fees and discount	$ 5,029,630	$ 4,275,417	$ 2,915,253
Merchant discount	3,088,190	3,027,268	2,505,673
ATM fee income	845,767	798,245	715,388
Other (includes no items in excess of 1% of total revenue)	2,142,214	1,747,174	1,866,366
	$ 11,105,801	$ 9,848,104	$ 8,002,680

The principal components of "Other Expenses" in the consolidated statements of income are:

	2008	2007	2006
Advertising	$ 707,388	$ 497,669	$ 446,369
Merchant card	2,337,442	2,249,933	1,914,769
Cash management royalties	219,244	311,563	320,509
Software	748,560	645,031	561,146
Provision for cash management account losses	865,000	450,000	200,000
Legal fees	284,485	176,028	215,692
Delivery and transportation	374,853	354,036	357,362
Stationary and supplies	458,465	448,064	442,994
Other (includes no items in excess of 1% of total revenue)	3,440,797	2,702,384	2,448,005
	$ 9,436,234	$ 7,834,708	$ 6,906,846

Note 13. Earnings Per Share

The following data shows the amounts used in computing earnings per share and the effect on the weighted average number of shares of dilutive potential common stock. The potential common stock did not have an impact on net income. All information for all periods presented has been retroactively restated to reflect the 6-for-5 stock split in 2007.

	2008	2007	2006
Weighted average number of common shares, basic	2,820,240	2,846,542	2,895,464
Effect of dilutive stock options	47,628	69,652	54,946
Weighted average number of common shares and dilutive potential common stock used in diluted EPS	2,867,868	2,916,194	2,950,410

Options on approximately 35,460 shares and 44,370 shares were not included in the computation of diluted earnings per share for the years ended December 31, 2007 and 2006 because the exercise price of those options exceeded the average market price of the common shares. No shares were excluded from the computation of diluted earnings per share for the year ended December 31, 2008.

Note 14. Time Deposits

Remaining maturities on certificates of deposit are as follows:

2009	$ 199,846,234
2010	23,496,561
2011	4,711,506
2012	5,295,236
2013	702,221
Thereafter	5,000,000
	$ 239,051,758

Note 15. Financial Instruments With Off-Balance-Sheet Risk

The Bank is a party to credit related financial instruments with off-balance-sheet risk in the normal course of business to meet the financial needs of its customers. These financial instruments include commitments to extend credit, standby letters of credit and commercial letters of credit. Such commitments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated balance sheets.

The Bank's exposure to credit loss is represented by the contractual amount of these commitments. The Bank follows the same credit policies in making commitments as it does for on-balance-sheet instruments.

At December 31, 2008 and 2007, the following financial instruments were outstanding whose contract amounts represent credit risk:

	Contract Amount	
	2008	**2007**
Commitments to grant loans	$ 9,422,900	$ 8,064,043
Unfunded commitments under lines of credit	107,314,333	82,452,367
Commercial and standby letters of credit	1,148,733	4,427,858

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. The commitments for equity lines of credit may expire without being drawn upon. Therefore, the total commitment amounts do not necessarily represent future cash requirements. The amount of collateral obtained, if it is deemed necessary by the Bank, is based on management's credit evaluation of the customer.

Unfunded commitments under commercial lines of credit, revolving credit lines and overdraft protection agreements are commitments for possible future extensions of credit to existing customers. These lines of credit usually do not contain a specified maturity date and may not be drawn upon to the total extent to which the Bank is committed. The amount of collateral obtained, if it is deemed necessary by the Bank, is based on management's credit evaluation of the customer.

Commercial and standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Those letters of credit are primarily issued to support public and private borrowing arrangements. Essentially all letters of credit issued have expiration dates within one year. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Bank generally holds collateral supporting those commitments, if deemed necessary.

CFS maintains its cash accounts in several correspondent banks. The total amount by which cash on deposit in those banks exceeds the federally insured limits is approximately $2,985,000 at December 31, 2008.

Note 16. Fair Value Measurements

CFS adopted SFAS No. 157, "Fair Value Measurements" (SFAS 157), on January 1, 2008 to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. SFAS 157 clarifies that fair value of certain assets and liabilities is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants.

In February 2008, the FASB issued Staff Position No. 157-2 (FSP 157-2) which delayed the effective date of SFAS 157 for certain nonfinancial assets and nonfinancial liabilities except for those items that are recognized or disclosed at fair value in the financial statements on a recurring basis. FSP 157-2 defers the effective date of SFAS 157 for such nonfinancial assets and nonfinancial liabilities to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years. Thus, CFS has only partially applied SFAS 157. Those items affected by FSP 157-2 include other real estate owned.

In October 2008, the FASB issued Staff Position No. 157-3 (FSP 157-3) to clarify the application of SFAS 157 in a market that is not active and to provide key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. FSP 157-3 was effective upon issuance, including prior periods for which financial statements were not issued.

SFAS 157 specifies a hierarchy of valuation techniques based on whether the inputs to those valuation techniques are observable or unobservable. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect CFS's market assumptions. The three levels of the fair value hierarchy under SFAS 157 based on these two types of inputs are as follows:

Level 1 - Valuation is based on quoted prices in active markets for identical assets and liabilities.

Level 2 - Valuation is based on observable inputs including quoted prices in active markets for similar assets and liabilities, quoted prices for identical or similar assets and liabilities in less active markets, and model-based valuation techniques for which significant assumptions can be derived primarily from or corroborated by observable data in the market.

Level 3 - Valuation is based on model-based techniques that use one or more significant inputs or assumptions that are unobservable in the market.

The following describes the valuation techniques used by CFS to measure certain financial assets and liabilities recorded at fair value on a recurring basis in the financial statements:

Securities Available for Sale: Securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted market prices, when available (Level 1). If quoted market prices are not available, fair values are measured utilizing independent valuation techniques of identical or similar securities for which significant assumptions are derived primarily from or corroborated by observable market data. Third party vendors compile prices from various sources and may determine the fair value of identical or similar securities by using pricing models that considers observable market data (Level 2).

The following table presents the balances of financial assets and liabilities measured at fair value on a recurring basis as of December 31, 2008:

		Fair Value Measurements at December 31, 2008 Using		
Description	Balance as of December 31, 2008	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Available for sale securities	$ 91,635,902	$ —	$ 91,635,902	$ —

Certain financial assets are measured at fair value on a nonrecurring basis in accordance with GAAP. Adjustments to the fair value of these assets usually result from the application of lower-of-cost-or-market accounting or write-downs of individual assets.

The following describes the valuation techniques used by CFS to measure certain financial assets recorded at fair value on a nonrecurring basis in the financial statements:

Loans Held for Sale: Loans held for sale are carried at the lower of cost or market value. These loans currently consist of one-to-four family residential loans originated for sale in the secondary market. Fair value is based on the price secondary markets are currently offering for similar loans using observable market data which is not materially different than cost due to the short duration between origination and sale (Level 2). As such, the Bank records any fair value adjustments on a nonrecurring basis. No nonrecurring fair value adjustments were recorded on loans held for sale during the year ended December 31, 2008. Gains and losses on the sale are recorded within income from mortgage banking on the Consolidated Statements of Income. The Bank had no loans held for sale at December 31, 2008.

Impaired Loans: Loans are designated as impaired when, in the judgment of management based on current information and events, it is probable that all amounts due according to the contractual terms of the loan agreement will not be collected. The measurement of loss associated with impaired loans can be based on either the observable market price of the loan or the fair value of the collateral. Fair value is measured based on the value of the collateral securing the loans. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. The vast majority of the collateral is real estate. The value of real estate collateral is determined utilizing an income or market valuation approach based on an appraisal conducted by an independent, licensed appraiser outside of the Bank using observable market data (Level 2). However, if the collateral is a house or building in the process of construction or if an appraisal of the real estate property is over two years old, then the fair value is considered Level 3. The value of business equipment is based upon an outside appraisal if deemed significant, or the net book value on the applicable business' financial statements if not considered significant using observable market data. Likewise, values for inventory and accounts receivable collateral are based on financial statement balances or aging reports (Level 3). Impaired loans allocated to the Allowance for Loan Losses are measured at fair value on a nonrecurring basis. Any fair value adjustments are recorded in the period incurred as provision for loan losses on the Consolidated Statements of Income. The Bank had no impaired loans with a valuation allowance at December 31, 2008.

The fair value of a financial instrument is the current amount that would be exchanged between willing parties, other than in a forced liquidation. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for CFS's various financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument. SFAS No. 107 excludes certain financial instruments and all nonfinancial instruments from its disclosure requirements. Accordingly, the aggregate fair value amounts presented may not necessarily represent the underlying fair value of CFS.

The following methods and assumptions were used by CFS in estimating fair value disclosures for financial instruments:

Cash, short-term investments and federal funds sold: The carrying amounts of cash and short-term instruments approximate fair values.

Securities: Fair values for securities, excluding restricted stock, are based on quoted market prices. The carrying value of restricted stock approximates fair value based on the redemption provisions of the respective entity.

Loans: For certain homogeneous categories of loans, such as some residential mortgages, and other consumer loans, fair value is estimated using the quoted market prices for securities backed by similar loans, adjusted for differences in loan characteristics. The fair value of other types of loans is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities.

Cash management accounts: The carrying value of cash management accounts approximates their fair value. The future cash flows from these accounts are short-term in nature (less than 90 days) and the rate of return approximates current market rates.

Deposits: The fair value of demand deposits, savings accounts and certain money market deposits is the amount payable on demand at the reporting date. The fair value of fixed-maturity certificates of deposit is estimated using the rates currently offered for deposits of similar remaining maturities.

Short-term borrowings: The carrying amounts of federal funds purchased, borrowings under repurchase agreements, and other short-term borrowings maturing within ninety days approximate their fair values. Fair values of other short-term borrowings are estimated using discounted cash flow analyses based on CFS's current incremental borrowing rates for similar types of borrowing arrangements.

Long-term debt: The fair value of CFS's long-term borrowings are estimated using discounted cash flow analyses based on CFS's current incremental borrowing rates for similar types of borrowing arrangements.

Accrued interest: The carrying amounts of accrued interest approximate fair value.

Off-balance-sheet instruments: Fair values for off-balance-sheet, credit-related financial instruments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standing. For fixed-rate loan commitments, fair value also considers the difference between current levels of interest rates and the committed rates. The fair value of standby letters of credit is based on fees currently charged for similar agreements or on the estimated cost to terminate them or otherwise settle the obligations with the counterparties at the reporting date. At December 31, 2008 and 2007, the fair values of loan commitments and standby letters of credit were deemed immaterial.

The estimated fair values, and related carrying or notional amounts, of CFS's financial instruments are as follows:

	2008		2007	
	Carrying Amount	**Fair Value**	**Carrying Amount**	**Fair Value**
	(In Thousands)		*(In Thousands)*	
Financial assets:				
Cash and short-term investments	$ 16,854	$ 16,854	$ 14,948	$ 14,948
Securities	91,636	91,636	79,745	79,745
Restricted stock	4,290	4,290	2,716	2,716
Loans	358,917	377,445	329,332	338,122
Cash management accounts	31,620	31,620	26,875	26,875
Accrued interest receivable	2,288	2,288	1,932	1,932
Financial liabilities:				
Deposits	$ 427,741	$ 435,538	$ 383,214	$ 384,770
Short-term borrowings	6,000	6,000	14,000	14,000
Long-term debt	70,600	73,192	50,018	50,346
Accrued interest payable	799	799	1,015	1,015

CFS assumes interest rate risk (the risk that general interest rate levels will change) as a result of its normal operations. As a result, the fair values of CFS's financial instruments will change when interest rate levels change and that change may be either favorable or unfavorable to CFS. Management attempts to match maturities of assets and liabilities to the extent believed necessary to minimize interest rate risk. However, borrowers with fixed rate obligations are less likely to prepay in a rising rate environment and more likely to prepay in a falling rate environment. Conversely, depositors who are receiving fixed rates are more likely to withdraw funds before maturity in a rising rate environment and less likely to do so in a falling rate environment. Management monitors rates and maturities of assets and liabilities and attempts to minimize interest rate risk by adjusting terms of new loans and deposits and by investing in securities with terms that mitigate CFS's overall interest rate risk.

Note 17. Minimum Regulatory Capital Requirements

CFS and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory, possibly additional discretionary, actions by regulators that, if undertaken, could have a direct material effect on CFS's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, financial institutions must meet specific capital guidelines that involve quantitative measures of assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. A financial institution's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors. Prompt corrective action provisions are not applicable to bank holding companies.

Quantitative measures established by regulation to ensure capital adequacy require financial institutions to maintain minimum amounts and ratios (set forth in the table below) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets, and of Tier 1 capital to average assets. Management believes, as of December 31, 2008 and 2007, that CFS meets all capital adequacy requirements to which it is subject.

As of December 31, 2008, the most recent notification from the Federal Reserve Bank categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum total risk-based, Tier 1 risk-based, and Tier 1 leverage ratios as set forth in the table. There are no conditions or events since that notification that management believes have changed the institution's category.

CFS's actual capital amounts and ratios are also presented in the table.

	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	**Ratio**	**Amount**	**Ratio**	**Amount**	**Ratio**
			(Amount in Thousands)			
As of December 31, 2008:						
Total Capital (to Risk Weighted Assets):						
Consolidated	$ 56,184	12.5%	$ 35,980	8.0%	N/A	
Chesapeake Bank	$ 51,606	11.6%	$ 35,734	8.0%	$ 44,668	10.0%
Tier 1 Capital (to Risk Weighted Assets):						
Consolidated	$ 47,465	10.6%	$ 17,990	4.0%	N/A	
Chesapeake Bank	$ 46,021	10.3%	$ 17,867	4.0%	$ 26,801	6.0%
Tier 1 Capital (to Average Assets):						
Consolidated	$ 47,465	8.9%	$ 21,274	4.0%	N/A	
Chesapeake Bank	$ 46,021	8.7%	$ 21,094	4.0%	$ 26,367	5.0%
As of December 31, 2007:						
Total Capital (to Risk Weighted Assets):						
Consolidated	$ 62,939	15.5%	$ 32,489	8.0%	N/A	
Chesapeake Bank	$ 46,289	11.5%	$ 32,233	8.0%	$ 40,291	10.0%
Tier 1 Capital (to Risk Weighted Assets):						
Consolidated	$ 43,811	10.8%	$ 16,245	4.0%	N/A	
Chesapeake Bank	$ 41,248	10.2%	$ 16,116	4.0%	$ 24,174	6.0%
Tier 1 Capital (to Average Assets):						
Consolidated	$ 43,811	9.3%	$ 18,835	4.0%	N/A	
Chesapeake Bank	$ 41,248	8.8%	$ 18,654	4.0%	$ 23,318	5.0%

Note 18. Trust Preferred Capital Notes

On December 6, 2002, CFS Capital Trust I, a wholly-owned subsidiary of CFS, was formed for the purpose of issuing redeemable Capital Securities. On December 19, 2002, $10.3 million of trust preferred securities were issued through a pooled underwriting totaling approximately $340 million. The securities had a LIBOR-indexed floating rate of interest. The securities had a mandatory redemption date of January 7, 2033, and were subject to varying call provisions beginning January 7, 2008. The trust preferred capital notes were called and repaid by CFS on January 7, 2008. The principal asset of the Trust was $10.3 million of the Corporation's junior subordinated debt securities with like maturities and like interest rates to Capital Securities.

On July 2, 2007, CFS Capital Trust II, a wholly-owned subsidiary of CFS, was formed for the purpose of issuing redeemable Capital Securities. On July 5, 2007, $15.465 million of trust preferred securities were issued through a pooled underwriting totaling approximately $611 million. The securities have a LIBOR-indexed floating rate of interest that applies to $5.155 million. The remaining $10.31 million is fixed at 6.854%. The weighted-average interest rate for the year ended December 31, 2008 was 6.20%. The weighted interest rate as of December 31, 2008 was 6.32%. The securities have a mandatory redemption date of October 1, 2037, and are subject to varying call provisions beginning September 6, 2012. The principal asset of the Trust is $15.465 million of the Corporation's junior subordinated debt securities with like maturities and like interest rates to Capital Securities.

The Trust Preferred Securities may be included in Tier 1 capital for regulatory capital adequacy determination purposes up to 25% of Tier 1 capital after its inclusion. The portion of the Trust Preferred not considered as Tier 1 capital may be included in Tier 2 capital.

The obligations of CFS with respect to the issuance of the Capital Securities constitute a full and unconditional guarantee by the Corporation of the Trust's obligations with respect to the Capital Securities.

Subject to certain exceptions and limitations, CFS may elect from time to time to defer interest payments on the junior subordinated debt securities, which would result in a deferral of distribution payments on the related Capital Securities.

Note 19. Condensed Parent Company Financial Statements

The following parent company accounting policies should be read in conjunction with the related condensed balance sheets, statements of income, and statements of cash flows.

Investments in subsidiaries are accounted for using the equity method of accounting. The parent company and its subsidiaries file a consolidated federal income tax return. The subsidiaries' individual tax provisions and liabilities are stated as if they filed separate returns and any benefits or detriments of filing the consolidated tax return are absorbed by the parent company.

The parent company's principal assets are its investments in its wholly-owned subsidiaries. Dividends from the Bank are the primary source of funds for the parent company. The payment of dividends by the Bank is restricted by various statutory limitations. Banking regulations also prohibit extensions of credit by the Bank to the parent company unless appropriately secured by assets. As of December 31, 2008, the amount available for payment of additional dividends without prior regulatory approval from the Bank to the parent company is $12,776,509 or 41.8% of consolidated net assets.

Balance Sheets (Condensed)

	December 31, 2008	December 31, 2007
Assets		
Cash	$ 2,244,768	$ 14,345,651
Investment in subsidiaries	42,714,101	44,852,276
Premises and equipment, net	1,050,615	1,040,176
Other assets	1,249,388	321,027
Total assets	$ 47,258,872	$ 60,559,130
Liabilities and Shareholders' Equity		
Long-term debt	$ 530,205	$ 574,019
Trust preferred capital notes	15,465,000	25,775,000
Other liabilities	711,868	546,990
Shareholders' equity	30,551,799	33,663,121
Total liabilities and shareholders' equity	$ 47,258,872	$ 60,559,130

Statements of Income (Condensed)

	2008	2007	2006
Income - Dividends from subsidiaries	$ 1,221,553	$ 1,228,102	$ 1,219,775
Other	115,967	139,045	196,944
Total income	$ 1,337,520	$ 1,367,147	$ 1,416,719
Expenses - Interest expense	$ 994,017	$ 1,451,018	$ 928,486
Other expenses	738,307	746,494	659,554
Total expenses	$ 1,732,324	$ 2,197,512	$ 1,588,040
(Loss) before income taxes and equity in undistributed earnings of subsidiaries	$ (394,804)	$ (830,365)	$(171,321)
Allocated income tax benefit	484,505	626,388	405,679
Income (loss) before equity in undistributed earnings of subsidiaries	$ 89,701	$ (203,977)	$ 234,358
Equity in undistributed earnings of subsidiaries	4,511,206	4,549,117	3,716,186
Net income	$ 4,600,907	$ 4,345,140	$ 3,950,544

Statements of Cash Flows (Condensed)

	2008	2007	2006
Cash Flows from Operating Activities			
Net income	$ 4,600,907	$ 4,345,140	$ 3,950,544
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Depreciation	119,429	112,291	112,340
Equity in undistributed earnings of subsidiaries	(4,511,206)	(4,549,117)	(3,716,186)
Issuance of common stock for services	103,525	99,049	308,458
Stock-based compensation	104,000	115,155	118,000
Changes in other assets and liabilities:			
(Increase) decrease in other assets	(131,178)	(519,991)	464,241
Increase in other liabilities	164,878	283,020	15,220
Net cash provided by (used in) operating activities	$ 450,355	$ (114,453)	$ 1,252,617
Cash Flows from Investing Activities			
Purchases of premises and equipment	$ (129,868)	$ —	$ (2,069)
Investment in subsidiaries	—	(250,000)	(250,000)
Net cash (used in) investing activities	$ (129,868)	$ (250,000)	$ (252,069)
Cash Flows from Financing Activities			
Dividends paid	$ (1,144,763)	$ (1,001,865)	$ (927,950)
Curtailment of note payable	(43,814)	(41,475)	(39,260)
Repurchase of common stock	(1,046,043)	(1,273,858)	(1,164,312)
Redemption of trust preferred capital notes	(10,310,000)	—	—
Proceeds from issuance of trust preferred capital notes	—	15,465,000	—
Net proceeds from issuance of common stock	123,250	232,213	222,325
Net cash provided by (used in) financing activities	$ (12,421,370)	$ 13,380,015	$ (1,909,197)
Net increase (decrease) in cash	$ (12,100,883)	$ 13,015,562	$ (908,649)
Cash at beginning of year	14,345,651	1,330,089	2,238,738
Cash at end of year	$ 2,244,768	$ 14,345,651	$ 1,330,089

Yount Hyde & Barbour
Certified Public Accountants and Consultants

To the Board of Directors and Shareholders
Chesapeake Financial Shares, Inc.
Kilmarnock, Virginia

We have audited the accompanying consolidated balance sheets of Chesapeake Financial Shares, Inc. and Subsidiaries as of December 31, 2008 and 2007, and the related consolidated statements of income, changes in shareholders' equity and cash flows for the years ended December 31, 2008, 2007 and 2006. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Chesapeake Financial Shares, Inc. and Subsidiaries as of December 31, 2008 and 2007, and the results of their operations and their cash flows for the years ended December 31, 2008, 2007 and 2006 in conformity with accounting principles generally accepted in the United States of America.

Yount, Hyde & Barbour, P.C.

Winchester, Virginia
February 27, 2009

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION

Financial Overview: Chesapeake Financial Shares, Inc. (CFS), had a return on average equity in 2008 of 13.5% and a return on average assets of 0.89% compared to 13.7% and 0.97%, respectively, in 2007. Total assets at year-end were $538 million, representing an 11.4% increase over the December 31, 2007 balance of $483 million. The Company ended the year with total gross loans of $363.6 million, and total deposits of $427.7 million, up 9% and 11.6%, respectively. Asset quality remained strong with net allowance for loan losses to gross loans of 1.3%, and loans over thirty days delinquent at 1.3% of total loans. The Holding Company and the Bank continued to maintain their "well capitalized" status, the highest ranking available from the Federal Deposit Insurance Corporation (FDIC).

Summary of Results of Operations: Earnings for 2008 were $4,600,907 or $1.60 per share (fully diluted) compared to $4,345,140 or $1.49 per share in 2007, an increase of $255,767. The 5.9% increase in net income resulted from an 11.4% increase or $1,532,082 in noninterest income. Noninterest expense increased by 14.4% or $3,149,873 in 2008 over 2007. All noninterest income items were up in 2008. Cash Flow Services income increased by $754,213 or 17.6% in 2008. Total noninterest expense was up for the year due primarily to normal increases in operating expenses, however there was a significant increase of 12.3% in salaries and benefits.

Earnings for 2007 were $4,345,140 or $1.49 per share (fully diluted) compared to $3,950,544 or $1.34 per share in 2006, an increase of $394,596. The 10.0% increase in net income resulted from a 16.1% increase or $1,871,077 in noninterest income. Noninterest expense increased by 11.0% or $2,164,764 in 2007 over 2006. All noninterest income items were up in 2007. Cash Flow Services income increased by $1,360,164 or 46.7% in 2007. Merchant Card income increased by 20.8% or $521,595 in 2007. Total noninterest expense was up for the year due primarily to normal increases in operating expenses, however there was a significant increase of 27.1% in Cash Flow expenses.

Assets: Loan Portfolio: The loan portfolio is the largest component of earning assets for the Company and accounts for the greatest portion of total interest income. The gross loan portfolio totaled $363.6, $333.7 and $301.5 million for 2008, 2007, and 2006, respectively, representing an increase of 9% for 2008 over 2007, 10.7% for 2007 over 2006, and 7.1% for 2006 over 2005. The increase in 2008 was primarily in commercial loans, up 10.7% or $20.8 million, and real estate mortgage, up 15.5% or $12.8 million. Consumer loans decreased $2.3 million or 10%.

On December 31, 2008, the loan portfolio consisted of 58.8% commercial loans, 34.3% single-family residential and residential construction loans, and 5.8% consumer loans. The commercial loans consisted principally of business loans such as owner-occupied commercial development, retail, builders/contractors, medical, service and professional, hospitality, non-profits, marine industry, and a small portion of agricultural and seafood loans.

Total nonperforming assets consist of nonaccrual loans, restructured loans, repossessed and foreclosed properties, and other real estate owned. Nonperforming assets were $1,393,982 at December 31, 2008, which represented a decrease from $2,219,861 at December 31, 2007. Past due loans over thirty days were 1.3% of total loans at December 31, 2008. A significant portion of the nonperforming asset total is attributable to a group of residential construction loans in one of the Bank's markets. Any potential loss related to these loans has been incorporated in the allowance for loan losses.

Investment Securities: All of the CFS's securities are classified as securities available for sale. Securities may be classified as investment securities (held to maturity) when management has the intent and CFS has the ability at the time of purchase to hold the securities to maturity. Investment securities are carried at cost adjusted for amortization of premiums and accretion of discounts. Securities available for sale include securities that may be sold in response to changes in market interest rates, changes in the securities option or credit risk, increases in loan demand, general liquidity needs and other similar factors. Securities available for sale are carried at fair market value. Deposit growth, overnight and term borrowing, and investment portfolio liquidity provided funding for the increases in the loan portfolio.

The fair market value of the portfolio was $5,047,426 less than book value, net of the tax effect, at December 31, 2008, and exceeded book value by $804,772, net of the tax effect, at December 31, 2007. This is within risk limits established by the Board and the Asset/Liability Management Committee.

At year-end, total securities at fair market value were $91.6 million, up $11.9 million from the $79.7 million on December 31, 2007. Investments in securities of state and political subdivisions increased by $12.1 million or 57.4%.

Asset Quality-Provision/Allowance for Loan Losses: The provision for loan losses is a charge against earnings necessary to maintain the allowance for loan losses at a level consistent with management's evaluation of the credit quality and risk of the loan portfolio. The allowance for loan losses represents management's estimate of the amount adequate to provide for potential losses inherent in the loan portfolio. To achieve this goal, the loan loss provision must be sufficient to cover loans charged off plus any growth in the loan portfolio. In determining the adequacy of the allowance for loan losses, management uses a methodology, which specifically identifies and reserves for higher risk loans. A general reserve is established for non-specifically reserved loans. Loans in a non-accrual status and over ninety days past due are considered in this evaluation as well as other loans, which may be a potential loss. The status of nonaccrual and past due loans varies from quarter to quarter based on seasonality, local economic conditions, and the cash flow of customers.

The allowance for loan losses was $4,715,574 or 1.3% of gross loans less unearned discounts at year-end. This ratio was 1.3% on December 31, 2007, and 1.4% in 2006. The 2008 provision was $400,000. There was a provision of $160,000 in 2007 compared to the 2006 provision of $833,333. Loans charged off totaled $319,957 in 2008, $136,387 in 2007, and $747,721 in 2006. Recoveries for the same periods were $246,993, $22,751, and $56,817, respectively. Management and the Board of Directors believe that the total allowance at year-end was adequate relative to current levels of risk in the portfolio. However, continued loan growth may warrant additional provisions in the future.

Liabilities: Deposits: CFS depends on deposits to fund most of its lending activities, generate fee income opportunities, and create a market for other financial service products. Deposits are also the largest component of CFS's liabilities and account for the greatest portion of interest expense.

Deposits totaled $427.7, $383.2, and $358.8 million for 2008, 2007, and 2006, respectively, and represented an increase of 11.6% for 2008 over 2007 and an increase of 6.8% for 2007 over 2006. There was a 33.6% increase in certificates of deposit during 2008, while noninterest bearing deposits decreased by $1.2 million or 2% from $63.4 million on December 31, 2007. Savings and interest bearing demand deposit balances decreased during 2008 by 10.1% or $14.3 million to $126.5 million.

Net Interest Income: The principal source of earnings for CFS is net interest income. Net interest income is the difference between interest plus fees generated by earning assets and interest expense paid to fund those assets. As such, net interest income represents the gross profit from the Bank's lending, investment, and funding activities.

A large number of variables interact to affect net interest income. Included are variables such as changes in the mix and volume of earning assets and interest bearing liabilities, market interest rates, and the statutory Federal tax rate. It is management's ongoing policy to maximize net interest income through the development of balance sheet and pricing strategies while maintaining appropriate risk levels as set by the board.

Net interest income totaled $16.5, $14.5, and $14.3 million for 2008, 2007, and 2006, respectively, representing an increase of 13.8% for 2008 over 2007, 2% for 2007 over 2006, and 0.3% for 2006 over 2005. Loan demand was strong this year with total gross loans up 9% or $29.9 million for 2008 over 2007. Total interest expense was $13.2, $13.5, and $10.4 million for 2008, 2007 and 2006, respectively. On a tax equivalent annualized basis, the net interest margin was 4.0%, 4.1% and 4.2% for 2008, 2007 and 2006, respectively. The Bank's margins have been very stable and generally above peer through numerous rate cycles. The decline in the margin in 2008 was consistent with decreased margins in the industry. This is due to the tremendous competition for deposits in a falling yield environment and deposit competition from credit unions expanding trade areas.

Noninterest Income: For the year ended December 31, 2008 noninterest income was $15 million, an 11.4% increase over the 2007 amount of $13.5 million, which was a 16.1% increase over the 2006 amount of $11.6 million. The increase in 2008 was due to the increases in fiduciary income of $153 thousand, or 8.3%, Cash Flow income of $754 thousand, or 17.7%, and ATM income of $48 thousand, or 6%. Other income was up 22.6%; primarily due to the receipt of $255 thousand in VISA IPO redemption proceeds.

Noninterest Expenses: Total noninterest expenses increased 14.4%, or $3.1 million in 2008 over 2007. In 2007, total noninterest expenses increased 11% over 2006 and increased 8.1% in 2006 over 2005. The increase in 2008 was due to an increase in salaries and benefits of 12.3% or $1.3 million, occupancy expenses increased 6.7% or $212 thousand, the Cash Flow provision increased 92.2% or $415 thousand, advertising expenses were up $210 thousand or 42.1%, and software expenses were up 16.1% or $104,000. Other expenses increased by $872 thousand or 14%, which includes a $100,000 write-off of an investment in Freddie Mac preferred stock.

Liquidity, Interest Rate Sensitivity, and Inflation: The objectives of CFS's liquidity management policy include providing adequate funds to meet the needs of depositors and borrowers at all times, as well as providing funds to meet the basic needs for ongoing operations of CFS, and to allow funding of longer-term investment opportunities and regulatory requirements. The objective of providing adequate funding should be accomplished at reasonable costs and on a timely basis. Management considers CFS's liquidity to be adequate.

The Bank's primary sources of asset liquidity continue to be federal funds purchased, time deposits with other banks, securities maturing within one year, loan curtailments, and short-term borrowings. On December 31, 2008, approximately 52.7% of the total invested portfolio dollars matured or were repricing within one year as compared to 36.7% on December 31, 2007. The Bank's loan portfolio was liquid with 50.7% of all loan dollars maturing or repricing within one year. This loan liquidity ratio was 59.3% on December 31, 2007.

Other sources of asset liquidity include the normal amortization and prepayment of loans, sale of loans, and proceeds from the sale of repossessed assets and other real estate owned. The sale of loans through the secondary market operation enhances the liquidity position by providing both fixed and adjustable rate long-term mortgage options to our client base. Mortgage loans held for resale are stated at the lower of cost or market (or contract value), however, due to the quick turning of these assets, seldom do these loans represent more than 1% of total assets.

Bank management maintains overnight borrowing relationships with correspondent banks for up to $121 million, secured and unsecured. The Bank and CFS have access to additional secured borrowing for $4 million.

As of December 31, 2008, the Bank held $37,587 in repossessed assets and $1,218,141 in other real estate owned. These assets are being actively marketed through real estate channels and are near term secondary sources of liquidity. The Bank should realize no loss on disposal of these assets.

Since the assets and liabilities of a bank are primarily monetary in nature (payable in fixed, determinable amounts), the performance of a bank is affected more by changes in interest rates than by inflation. Interest rates generally increase as the rate of inflation increases, but the magnitude of the change in rates may not be the same. Interest rate sensitivity refers to the difference between assets and liabilities subject to repricing, maturity, or volatility during a specified period. Management's objective in controlling interest rate sensitivity is to reprice loans and deposits and make investments that will maintain a profitable net interest margin (see "Net Interest Income").

While the effect of inflation is normally not as significant as is its influence on those businesses that have large investments in plant and inventories, it does have an effect. There are normally corresponding increases in the money supply, and banks will normally experience above average growth in assets, loans and deposits. Also, general increases in the prices of goods and services will result in increased operating expenses.

Shareholders' Equity: Capital represents funds, earned or obtained, over which management can exercise greater control in comparison with deposits and borrowed funds. Future growth and expansion of CFS is dictated by the ability to produce capital. The adequacy of CFS's capital is reviewed by management on an ongoing basis with reference to the size, composition and quality of CFS's asset and liability levels and consistent with regulatory requirements and industry standards. Management seeks to maintain a capital structure that assures an adequate level to support anticipated asset growth and absorb potential losses.

Federal regulators have adopted minimum capital standards. Specifically, the guidelines categorize assets and off balance sheet items into four risk weighted categories. The minimum ratio of qualifying total capital to risk weighted assets is 8%. For CFS, Tier 1 capital is composed of common equity and retained earnings. Tier 1 capital to risk weighted assets and Tier 1 capital to average assets (called leveraged capital) must be 4%. On December 31, 2008, the Company had ratios of Tier 1 risk based capital to risk weighted assets of 10.6%, total risk based capital to risk weighted assets of 12.5%, and Tier 1 leverage capital of 8.9%. At December 31, 2007, these ratios were 10.8%, 15.1% and 9.3%, respectively. At December 31, 2008, these ratios for the bank were 10.3%, 11.6% and 8.7%, respectively, well above the regulatory minimums and exceeded the requirements for FDIC's "well capitalized" designation. As of December 31, 2008, the Company's primary capital to asset ratio was 8.8%.

Dividend and Market Information: The Company's stock trades on the "OTC" (Over The Counter) market under the symbol "CPKF". The Company raised its dividend to $0.405 per share in 2008, an increase of $0.055 over 2007. This increase followed a $0.029 per share dividend increase from $0.321 in 2006 to $0.35 in 2007. There was a 6-for-5 stock split in the form of a 20% stock dividend with a record date of October 15, 2007 and all per share information for all periods presented has been retroactively restated. Trades in the Company's common stock occurred infrequently and generally involved a relatively small number of shares. Based on information available, the selling price for the Company's common stock ranged during 2008 from $15.05 to $19.99, and during 2007, from $15.50 to $20.50. Such transactions may not be representative of all transactions during the indicated periods, of the fair value of the stock at the time of such transactions, due to the infrequency of trades and the limited market for the stock. Management attributes the Company's ability to maintain stable share prices, during hard economic times, to its record earnings over the past several years. At December 31, 2008, there were 2,795,413 shares of Company's common stock outstanding held by approximately 235 holders of record.

DIRECTORS AND OFFICERS

Chesapeake Financial Shares, Inc. — Directors

Jeffrey M. Szyperski
Chairman of the Board,
Chief Executive Officer and President

Douglas D. Monroe, Jr.
Vice Chairman

Eugene S. Hudnall, Jr.
Owner and Operator
Kilmarnock Mini Storage

Thomas E. Kellum
Vice President
W. Ellery Kellum, Inc.

Katherine W. Monroe
Shareholder

Bruce P. Robertson
President
Shirley Pewter Shop

William F. Shumadine, Jr.
Former President of
Central Fidelity Bank

Robert J. Singley
Partner
RJS & Associates, Inc.

Thomas G. Tingle, AIA
President
Guernsey Tingle Architects

Chesapeake Bank — Directors

Jeffrey M. Szyperski
Chairman of the Board,
Chief Executive Officer and President

David E. Bush, CPA, CFP
Member
Witt Mares Eggleston Smith, PLC

Charles C. Chase, II
President, Chase Properties, Inc.

James M. Holmes, Jr.
President
Chesapeake Health Services

Eugene S. Hudnall, Jr.
Owner and Operator
Kilmarnock Mini Storage

Thomas E. Kellum
Vice President
W. Ellery Kellum, Inc.

Douglas D. Monroe, Jr.
Chairman Emeritus
Chesapeake Bank

Albert C. Pollard
President
Pollard Properties, Inc.

Thomas G. Tingle, AIA
President
Guernsey Tingle Architects

Harry M. Ward
Director
Insurance Pool for the Virginia
School Boards Association and
Legislative Services

Corporate Officers

Jeffrey M. Szyperski
Marshall N. Warner
John H. Hunt, II
John K. O'Shaughnessy
Larry T. Lawrence
J. Mark Monroe
Gegory V. Powell
Trudy M. Quinto
Dianne D. Hall
Kathleen S. Banks
Steven D. Callis
Robert G. Castleman
Pamela D. Chapman
Sherri L. Clowser
Melissa A. Crawford
Melissa A. Denison
Bryan D. Edmonds
Tucker K. Edmonds
Mark J. Eggleston
Rebecca A. Foster
John H. Geier
David W. Homard
Catherine B. Jackson
Ryan C. Kent
Suzanne D. Keyser
Cecelia G. Klink
Jean H. Light
Roberta R. LeDoux
Patricia R. Lewis
W. J. McLachlan
P. Kim Miller
Paula A. Milsted
Catherine D. Mise
Johanna M. Northstein
Tracy R. Pastella
Ann Marie Pruitt
Carol C. Rakes
Thomas H. Richardson
Kristie K. Smith
Sandra L. Smith
Betty Sue Spence
N. Gregory Spryn
Teresa W. Stewart
Paul L. Wegkamp, Jr.
Sherry T. Williams
Kevin S. Wood

Chesapeake Investment Group, Inc. — Directors

J. Mark Monroe, President
Leland T. James
William F. Shumadine, Jr.
Jeffrey M. Szyperski
Marshall N. Warner

Chesapeake Trust Company, Inc. — Directors

Gregory V. Powell, President
John H. Hunt, II
Ted M. Kattmann
John K. O'Shaughnessy
Jeffrey M. Szyperski
Marshall N. Warner

Chesapeake Financial Group, Inc. — Directors

J. Mark Monroe, President
John H. Hunt, II
John K. O'Shaughnessy
Jeffrey M. Szyperski
Marshall N. Warner

Chesapeake Investment Services — Directors

Trudy M. Quinto, President
John H. Hunt, II
John K. O'Shaughnessy
Jeffrey M. Szyperski
Marshall N. Warner

Chesapeake Bank — Business Advisory Boards

Peninsula
David E. Bush, CPA, CFP
Vincent A. Campana
Catherine B. Chaplain
Richard A. Costello
J. Terry Deaver
Perry M. DePue
Patrick G. Duffeler
Vernon M. Geddy, III, Esq.
Stephen H. Montgomery
Bruce P. Robertson
John M. Sadler, Esq.
Thomas G. Tingle, AIA

Northern Neck
Stuart A. Bunting
Fred E. Burke, Jr.
James N. Carter, Jr.
Sandra H. Hargett
Susan F. Hill
Joseph P. Hudnall
Thomas E. Kellum
William R. Lee
Samuel E. Monroe, II
W. Bruce Sanders
Matson C. Terry, II, Esq.

Middle Peninsula
Dr. Layton H. Beverage
Nancy H. Dykeman, CPA
Elwood G. Everington
J. Scott Finney
Joseph K. Moorman
Harvey B. Morgan
David A. Morris, D.D.S.
David W. Muffelman, M.D.
Guy R. A. Sorensen
J. V. White
J. Stephen Wiseman


We've always been a
glass half-full kind of bank.

Chesapeake Financial Shares, Inc.

Chesapeake Bank

Chesapeake Investment Group

P.O. Box 1419 • Kilmarnock, Virginia 22482 • 804-435-1181
www.chesbank.com • Ticker Symbol CPKF
www.chesvest.com